

# Increase the Minimum Tax on S-Corps and C-Corps

(Draft as of 7/28/03)

by David Downs

## 1. **What it is:**

Every corporation subject to the Arizona Income Tax Act of 1978 that engages in a trade or business or has income from the state must file an Arizona corporate income tax return. This includes C-corporations, Limited Liability Companies (LLC) classified as corporations, and S-corporations taxed under Subchapter S of the Internal Revenue Code. C-corporations and LLCs file Form 120 income tax return and S-corporations file Form 120S.

Currently, the net income of taxpayers that file Form 120 is subject to a tax rate of 6.968% or a minimum tax of \$50.

S-corporations are subject to income tax only if they have income subject to tax at the corporate level on the federal Form 1120S. The tax is 6.968% of net income or a minimum of \$50. The S-corporation is subject to the \$50 minimum tax only if it has income subject to tax at the federal level.

The proposal before this commission is increasing the minimum tax on corporations from \$50 to \$200.

## 2. **How it would be administered:**

The minimum tax is collected with the filing of the corporate income tax return or the filing of an extension by the original due date of the return. The tax is transmitted either by check or electronic funds transfer to the State.

The administration process does not change with an increase in the amount of the minimum tax.

## 3. **Impact on Existing Revenue Systems:**

We do not expect the increase in the minimum tax to directly affect other revenue systems nor have a secondary affect on other current revenue sources.

## 4. **Cost:**

The cost of administering the increase to the minimum corporate tax would be nominal because the mechanisms for collecting and processing the tax are already in place.

We believe the compliance cost to corporate taxpayers would be nominal as a minimum tax is already required and the preparing and remitting processes remain the same.

## 5. **Policy Considerations:**

### **A. Equity**

A minimum tax is evenly applied across all corporate taxpayers in horizontal equity. The tax is regressive for vertical equity where taxpayers with little, zero or negative net income pay a disproportionate rate.

### **B. Economic Vitality**

Arizona is one of six states among the 10 comparison states to apply a minimum corporate income or similar tax such as franchise, business and occupation, net worth, or excise tax. The six states are

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Arizona, California, Georgia, New Mexico, Oregon and Utah with a minimum tax of \$50, \$800, \$10, \$50, \$10 and \$100, respectfully. Georgia's minimum net worth tax is a graduated rate of \$10 to \$5,000. Utah applies the minimum tax of \$100 for each corporation included in the filing where as the other states apply the tax per return.

## C. Volatility

The level of revenue raised by the corporate minimum tax is mildly volatile as it is subject to economic swings, net profits or other business climate factors. It is based on entities subject to filing a return with little or no net income. In economic times where businesses incur net operation losses, there may be a higher incidence of minimum tax collections. In better economic times, businesses that become profitable will pay taxes in excess of the minimum. A number of the entities that currently pay the minimum tax are dormant or have little activities that are not affected by the economic climate. The revenue related this portion should be more consist and less volatile.

For the 7-year period of 1994 to 2000, the average C-corporation filers with zero or negative income is 48% of all filers. This indicates that the volatility is mild.

<u>Year</u>	<u># of C-Corp Filers w/ \$0 or Negative Income</u>	<u>Total C-Corp Filers</u>	<u>Percent of w/ \$0 or Negative Income Filers</u>
1994	20,261	41,760	48.5%
1995	20,700	42,498	48.7% (Estimate)
1996	20,953	42,986	48.7%
1997	24,447	53,980	45.3%
1998	25,750	53,997	47.7%
1999	26,231	53,773	48.8%
2000	<u>26,485</u>	<u>52,622</u>	<u>50.3%</u>
Average	23,547	48,802	48.2%

For the 7-year period of 1994 to 2000, the percentage of C-corporation filers paying the minimum tax is 66% of all filers. This indicates that the volatility is mild with a slightly increasing trend.

<u>Year</u>	<u>Number of C-Corp Filers \$50 minimum tax</u>	<u>Total C-Corp Filers</u>	<u>Percent of C-Corp Filers \$50 minimum tax</u>
1994	26,711	41,760	64.0%
1995	26,621	42,498	62.6%
1996	26,432	42,986	61.5%
1997	36,250	53,980	67.2%
1998	36,275	53,997	67.2%
1999	36,430	53,773	67.7%
2000	<u>36,387</u>	<u>52,622</u>	<u>69.1%</u>
Average	32,158	48,802	65.9%

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## D. Simplicity

We believe the application of the corporate minimum tax is simple and straightforward.

## 6. Economic Impact:

For the 2000 tax year, there were 69% of corporate returns, Form 120, filed with the minimum tax of \$50. In the same year, 0 % of the S-corporate returns, Form 120S, were filed with the minimum tax. The following chart presents the increase in annual revenue of \$5.46 million should the minimum be increased from \$50 to \$200 based on 2000 filing results.

<u>Return Type</u>	<u>Returns w/ Minimum Tax</u>	<u>Total Returns</u>	<u>Percent w/ Minimum Tax</u>	<u>\$50 Minimum Tax Revenue</u>	<u>\$200 Minimum Tax Revenue</u>	<u>Revenue Increase</u>
C-Corp	36,387	52,622	69%	\$1,819,350	\$7,277,400	\$5,458,050
S-Corp	0	50,973	0%	\$0	\$0	\$0
Totals	36,387	103,595	35%	\$1,819,350	\$7,277,400	\$5,458,050

## 7. Other:

Arguments of increasing the minimum tax to \$200 are the following:

It will cover more administrative costs of the corporate income tax filings.

It requires few changes to the existing processes.

It is simple to apply and administer, and for taxpayers to comply.

Arguments against increasing the minimum tax to \$200 are as follows:

The minimum tax would exceed all comparison states except for California.

The tax is applied to entities that have none or negative earnings as a regressive tax.